Supreme Court, U.S.
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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION

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STATEMENT PURSUANT TO RULE 29.6

Respondent, Makor Issues&Rights Ltd., is the only respondent in corporate form and is wholly owned by Gruner Investments Anstalt, Vaduz, Liechtenstein (a private company).

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REASONS FOR DENYING THE PETITION

The petition for a writ of certiorari should be denied. The United States Court of Appeals for the Seventh Circuit properly recognized and applied the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (the "PSLRA"), and, in particular, the requirement that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." PSLRA § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit did not, as Petitioners contend, employ an inappropriately lax standard that was at odds with either the express language of the PSLRA or the interpretation of the statute adopted by other Circuits. Petitioners expend enormous energy portraying the existing case law as inconsistent, divided, and chaotic. In truth, much of what Petitioners focus on are really only differences in semantics, not substance. In any event, the allegations in this case are so strong and highly particularized that the Complaint satisfies any formulation of the PSLRA pleading requirements. As such, this is an inappropriate case for this Court to address the PSLRA pleading standard.

I. PETITIONERS MISREPRESENT THE STANDARD APPLIED BY THE SEVENTH CIRCUIT

Straining to create an issue for review, Petitioners suggest that the Seventh Circuit — in its unanimous decision — applied an improperly "lax" standard in adjudging that Respondents adequately pled scienter under the PSLRA. *See, e.g.*, Pet. at 23 ("The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably '***could***' draw an inference of scienter."). Petitioners are wrong. The Seventh Circuit properly recognized that,

although the PSLRA "did not impose a more stringent substantive scienter standard, ***it did unequivocally raise the bar for pleading scienter***." Pet. App. A at 18a (emphasis added). "Not only must plaintiffs meet a particularity requirement; they must also meet a substantive requirement by pleading sufficient facts to create '***a strong inference' of scienter***." *Id.* (emphasis added). The Seventh Circuit observed:

> Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is "possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief," ***the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading — one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b)***.

Id. at 6a-7a (emphasis added) (citation omitted).

After addressing various errors in the District Court's decision dismissing the Second Amended Consolidated Class Action Complaint (the "Complaint"), the Seventh Circuit stated:

> All of this will not affect the ultimate outcome of this case, however, ***unless the plaintiffs can clear another, even more arduous, hurdle: adequately alleging scienter***. In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had "not prevented abuse of the securities laws by private litigants." To address this perceived abuse, the PSLRA

> changes the threshold pleading rules by requiring that the complaint ". . . state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Id. at 16a-17a (emphasis added) (citation omitted). The Court also stated:

> Under the PSLRA, a securities fraud complaint must . . . "state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." In other words, ***plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that defendants likely intended "to deceive, manipulate, or defraud."***

Id. at 7a (emphasis added). *See also id.* at 1a (noting "the ***heightened pleading requirements*** of the [PSLRA]") (emphasis added); *id.* at 22a ("We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a ***strong inference of scienter***.") (emphasis added); *id.* at 23a ("Creating the required ***strong inference that Birck***[1] ***knew*** about the 5500's market weakness is more difficult.") (emphasis added); *id.* at 24a ("a ***strong inference of scienter***") (emphasis added); *id.* at 25a ("***strong inference that Notebaert***[2] ***knew***") (emphasis added).[3]

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1. Michael J. Birck, Tellabs' Chairman and former CEO.

2. Richard C. Notebaert, Tellabs' CEO and President.

3. In addition, the Seventh Circuit made clear that a plaintiff must establish the requisite "strong inference" of scienter with respect (Cont'd)

In fact, the phrase "strong inference" appears no fewer than twenty times in the Seventh Circuit's opinion, and nowhere in the opinion does the Court state that anything less than a "strong inference" will suffice to meet the pleading requirements of the PSLRA.

II. THE COMPLAINT PLEADS FACTS THAT GIVE RISE TO A "STRONG INFERENCE" OF SCIENTER UNDER ANY FORMULATION OF THE PSLRA STANDARD

This is not the sort of marginal case the PSLRA was intended to address. The Complaint passes muster even under the most restrictive formulation of the PSLRA pleading requirements. Accordingly, this is not the appropriate case for this Court to address whatever variations may exist among the Circuits in the articulation of the "strong inference" standard.

The Complaint is unusually detailed in that, among other things, it identifies 27 confidential sources — all closely connected with Tellabs — with knowledge and information concerning the Company's serious problems and Petitioners' awareness thereof. The Complaint specifies the position held by each source and the dates of his or her employment with the Company. The Seventh Circuit explained:

(Cont'd)

to each defendant: "While we will aggregate the allegations in the complaint to determine whether it creates a ***strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant*** in multiple defendant cases." Pet. App. A at 22a (emphasis added).

> The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

Pet. App. A at 11a.[4]

The Seventh Circuit found that the Complaint provides detailed facts to support the allegation that, by January 2001, demand for Tellabs' "best seller" — the TITAN 5500 — was

4. The confidential sources, who corroborate each other and who are corroborated by other facts pleaded in the Complaint, include: two "Tellabs marketing manager[s]," a "Tellabs executive account manager and regional manager," three "high-level Tellabs sales executive[s]," a "Tellabs shipping supervisor," a "mid-level Tellabs employee involved in distribution," a "Tellabs senior business manager," two "Tellabs sales director[s]," a "Tellabs project manager," a "Tellabs customer accounts representative," a "Tellabs regional sales director," a "Tellabs installations supervisor," a "Tellabs sales manager," a "Tellabs materials manager," a "Tellabs manager in the business development area," a "Tellabs marketing strategy executive," a "Tellabs market analyst," a "high-level SALIX/ Tellabs operations executive," a "Tellabs operations manager," a "Tellabs engineer who held a variety of management positions at Tellabs," a "Tellabs senior designer," a "Tellabs customer manager," a "Tellabs team project manager," and a "Tellabs consultant who worked for value added resellers [*i.e.*, "third parties that work along with Tellabs to handle customer services, including engineering site surveys, installations, and testing services" and "also act as distributors of Tellabs' products"]." Twenty-six of the twenty-seven sources were at Tellabs during the Class Period. (One high-level sales executive who worked at the Company for many years left just prior to the Class Period.) Complaint at 1-4.

declining, including that Verizon, Tellabs' largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001; that customers in Latin America and Central America were no longer buying the product; that, by late 2000, according to a couple of confidential sources, Tellabs had excess TITAN 5500s on hand because of a lack of demand; that one confidential source revealed that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500; that the report, which was completed "in or about early 2001," showed that the market need for the TITAN 5500 was evaporating; and that, based on that research, Tellabs' marketing strategy department distributed an internal memorandum concluding that revenue from the TITAN 5500 could decline by about $400 million. Pet. App. A at 11a. In light of the serious problems affecting the TITAN 5500, the Seventh Circuit found actionable:

> — Notebaert's assurance during a March 8, 2001 conference call with analysts: "We're still seeing [the TITAN 5500] . . . maintain its growth rate; it's still experiencing strong acceptance."[5]
>
> — The response by Notebaert and Birck in Tellabs' 2000 Annual Report, published in February 2001, to the frequently asked question, "[A]re you worried that the [TITAN 5500] has peaked?" Petitioners stated, without qualification, "No. . . . Although we introduced the product nearly 10 years ago, it's still going strong."

Id. at 12a.

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5. The District Court, too, held this statement to be actionable. Pet. App. B at 50a.

The Seventh Circuit also held, as did the District Court (Pet. App. B at 52a-53a), that Petitioners' representations concerning the purported availability of, and demand for, the TITAN 6500, one of Tellabs' most significant new products, were actionable in light of the Complaint's allegations that the TITAN 6500 was, in fact, far behind schedule, failing lab tests, and not ready for release (*id.* at 32a, 51a[6]). Thus, both the Seventh Circuit, and the District Court, determined that Respondents adequately alleged that the following statements were deceptive:

> — On December 11, 2000, the first day of the Class Period, Tellabs flatly stated, "The TITAN 6500 system is available now."
>
> — On March 8, 2001, Notebaert told analysts, "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand."
>
> — Again, on April 6, 2001, in response to an analyst's question whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter, Notebaert stated, "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong."

Pet. App. A at 13a.

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6. The District Court noted: "Plaintiffs support their allegations [regarding the TITAN 6500] with information from numerous confidential sources who worked at Tellabs." Pet. App. B at 51a.

The Seventh Circuit further concluded, as did the District Court, that Plaintiffs pled "with sufficient particularity . . . the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s" and therefore adequately alleged that Defendants falsely represented Tellabs' financial results for the fourth quarter of 2000:

> According to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.
>
> ***While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them.*** The complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree, that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Id. at 14a (emphasis added).[7, 8]

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7. The District Court found the allegations of channel stuffing, as well as allegations of backdating sales, to be sufficiently particularized. Pet. App. B at 56a-58a. The District Court noted:

(Cont'd)

The Seventh Circuit then determined, with respect to each of the actionable misstatements, that the Complaint alleges "facts that give rise to a ***strong inference*** of scienter" (emphasis added) on the part of Notebaert and, since Notebaert was Tellabs' CEO, on the part of the Company as well:

> First, as for the TITAN 5500, the Probe Research report revealed, "in or about early 2001," that the market for the TITAN 5500 had faded. In reaction to this news, Tellabs's marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million. According to one confidential source, a Tellabs market analyst who worked for the company throughout the class period, internal reports

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(Cont'd)

> Plaintiffs back their contentions [of channel stuffing] with allegations supported by at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want. . . . These sources corroborate each other and suggest that the information is reliable. Plaintiffs identify specific customers whom Tellabs allegedly over-inventoried, namely Telcobuy and Verizon.

Id. at 56a-57a.

8. The Seventh Circuit noted, as well, that Plaintiffs "identify a series of what turned out to be overstated revenue projections made by Tellabs, which, according to the complaint, were meant to induce investors to purchase Tellabs stock." Pet. App. A at 14a. The Seventh Circuit held that "Tellabs's warnings were not particularized enough for it to claim shelter under the PSLRA's safe harbor provision." *Id.* at 16a.

> revealed by March 2001 that the market for the 5500 was drying up. Yet, in April 2001, Notebaert told financial analysts that "everything we hear from the customers indicates that our in-user demand for services continues to grow." While it is conceivable that Notebaert had yet to see the reports suggesting his company was in trouble ("in or about early 2001" is somewhat vague), the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false. According to another confidential source, a Tellabs business manager, Notebaert stayed on top of the company's financial health through weekly conversations with his fellow executives. Given the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information suggesting that his statements were false.

Id. at 23a.[9]

With respect to Notebaert's awareness that the representations regarding the availability of the TITAN 6500 were false, the Seventh Circuit stated:

> According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN

9. Evidencing its close attention to the heightened PSLRA pleading standards, the Seventh Circuit concluded that "the plaintiffs did not meet the strict PSLRA standards for pleading Birck's scienter." Pet. App. A at 24a.

> 6500 during the class period. If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes. According to a Tellabs sales director, Notebaert saw weekly sales reports and production projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a ***strong inference***," 15 U.S.C. § 78u-4(b)(2), ***that Notebaert knowingly lied*** when he informed investors that the 6500 was "available now" and was "being shipped."

Id. at 24a-25a (emphasis added).

The Seventh Circuit also found that, as with the TITAN 5500 and 6500, the Complaint "contains enough detail to establish a ***strong inference*** that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues." *Id.* at 25a (emphasis added). The Court stated:

> Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert "worked directly with Tellabs' sales personnel" to effect the channel stuffing. Another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered. He

> claimed that Notebaert "unquestionably knew" about the channel stuffing.

Id.[10] The extraordinarily detailed Complaint satisfies any Circuit's formulation of the PSLRA pleading standard.

Petitioners try to make much of the Seventh Circuit's failure to take account of purported "competing innocent inferences" to be drawn from facts alleged in the Complaint. *See, e.g.*, Pet. at 15. Yet, fairly considered, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case. Accordingly, whether or not inferences of an innocent mental state are considered and balanced against the inferences of scienter would not affect the outcome of this case. The inferences of culpability are not only the most plausible or the stronger inferences to be drawn here, they are the ***only*** inferences.

Petitioners' argument that "the record revealed no apparent motive for Notebaert to engage in fraud . . . or any benefit either to him or the company" (Pet. at 15) defies common sense. Notebaert, whose livelihood and business reputation depended on the success of the Company, no doubt was extremely concerned with its well-being. The public revelation of significant problems affecting Tellabs' key products, including that one of its most important new products, the TITAN 6500, was not ready for release, surely would have jeopardized the Company's performance and prospects in a highly competitive and troubled market.

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10. The Seventh Circuit further determined: "since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here." Pet. App. A at 25a-26a.

Notebaert's natural desire to protect his Company from the adverse effects of publicizing that the products on which its fortunes depended were not selling and did not work makes complete sense. *See Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 656 (8th Cir. 2001) ("common sense would suggest that [defendant's desire to maintain company's profitability or credit rating] may be the very motives that prompt many cases of deceptive misstatements").[11]

Moreover, motive is not an essential element of a § 10(b) claim.[12] *See Novak v. Kasaks*, 216 F.3d 300, 306, 311 (2d Cir. 2000). The Seventh Circuit (Pet. App. A at 17a-18a) and virtually every other Court of Appeals that has considered the issue[13] have recognized that reckless disregard for the truth still constitutes scienter under § 10(b).

Nor do Tellabs' announcements on April 6 and April 18, 2001, in which the Company, among other things, modified

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11. No inference adverse to Respondents should be drawn from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal insider selling of Tellabs stock while in possession of material nonpublic information.

12. In addition, because Respondents did not have access to discovery when drafting the Complaint, it would be unfair to require them to know or speculate as to what was in Petitioners' minds.

13. *See, e.g., Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343-44 (4th Cir. 2003); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38 (1st Cir. 2002); *Green Tree*, 270 F.3d at 653-54; *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407-09 (5th Cir. 2001); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76-77 (2d Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 548, 550 (6th Cir. 2001); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999); *In re Advanta Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999).

its previous guidance, give rise to an innocent inference. Tellabs revised its estimates of 2001 performance only when the release of disappointing first quarter 2001 results forced its hand. Moreover, at the very same time Tellabs modified its guidance, Notebaert falsely assured analysts that Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter: "[W]e should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." The Seventh Circuit found these statements actionable. Pet. App. A at 13a.

Likewise, Tellabs' attempt to accelerate sales by channel stuffing can hardly be viewed as innocent in light of the Complaint's allegations that, according to one confidential source (a high-level Tellabs sales executive), Tellabs employees actually fabricated purchase orders for products customers had not ordered (Pet. App. A at 25a); that, according to another source, Tellabs sent unwanted TITAN 5500s to such customers as Verizon and Telcobuy (Pet. App. B at 56a-57a); and that the Chairman of Verizon, Tellabs' largest customer, even called Tellabs to complain about channel stuffing (Pet. App. A at 14a). Yet another source, a Tellabs marketing manager, revealed that, to pull TITAN 5500 sales to such large customers as SBC and Sprint from the first quarter 2001 into the fourth quarter 2000, Tellabs backdated sales. Pet. App. B at 58a.

In short, considered individually and cumulatively, the facts alleged compel a powerful inference of scienter that would satisfy even the most stringent reading of the PSLRA. The Complaint supports an inescapable inference that Petitioner Notebaert, who was responsible for managing the Company at the very highest level, was fully aware that the very serious problems affecting sales of Tellabs' core products jeopardized

the Company's overall performance and prospects. *See, e.g.*, *Kinder-Morgan*, 340 F.3d at 1106; *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 943 n.21 (9th Cir. 2003); *Zonagen*, 267 F.3d at 424-25; *Advanta Corp.*, 180 F.3d at 539.

CONCLUSION

The petition for a writ of certiorari should be denied.

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